The Boston Office Market And It's Management; The Present and Future of the Downtown-Financial District Office Market

Draft
Background Notes
For a Presentation to
The Federal Reserve Bank of Boston

Stephen Coyle, Director
Boston Redevelopment Authority

September 11, 1986

Raymond L. Flynn, Mayor
City Of Boston

The Boston Office Market

And It's Management

Boston's office market is in extraordinary good health, and the City's planning and development strategy has a major stake in keeping it that way. A lean and robust office market is key to Boston's strategy for harnessing the growth economy to bridge the gap between the rich and the poor.

Managing the office market means orderly growth, in time and in place. In this strategy the Financial District will continue to dominate even as the office industry spreads. The Financial District will extend beyond South Station to encompass the Fan Piers; the remainder of Ft. Point Channel will await a later era of mixed use planning and infrastructure development. Back Bay will envelope Parcel 18 on the relocated Orange Line. The Bulfinch Triangle and Charlestown will provide much needed Class B space. But the Charles River will continue to be wider than it seems.

How fast Boston's office inventory will develop can and must be managed. Achieving a goal of 1.6 to 2.0 million square feet a year consonant with an 8% to 12% vacancy rate is vital for an orderly office market and the spin-off of benefits in the form of jobs, housing, neighborhood revival and tax revenue. Office market good health is essential to the attractiveness of Boston as a place to work and live, and a reliable place to invest for the financial community. An office market in good working order is required if Boston is to reap development dividends in the form of housing and job training linkage payments, affordable housing and inclusionary zoning, jobs for residents goals, minority business equity participation, parcel-to-parcel linkage, neighborhood participatory planning and advocacy,- all of the measures designed to channel the fruits of the boom economy to those who have lagged behind.

Boston's office market can be managed. Supply and demand over the next five years (1986-90) combines a known quantum, namely the flow of development projects constrained in large part by public policy, and the flow of demand for office space as seen in employment projections for the Boston economy, office space absorption trends, and the early pre-leasing of space equivalent to one-fourth of the demand projected for 1986, 1987, and 1988. Newly adopted and proposed planning and zoning tools, including allowable heights and use by downtown sub-districts will facilitate the management of office space supply in relation to demand. Beyond 1990, the office market can be successfully managed by constraining and channeling office space supply, in time and place, in relation to demand and planning and development goals.

Managing the office market is also necessary to achieve desired balance in planning and development. Boston needs residential as well as commercial development, neighborhood revival as well as downtown development, jobs for resident workers as well as employment growth, land use constraints and height limits as well as new office space, the remarkable contribution of the new as well as historic preservation, private entrepreneurship as well as enhancement of the public realm, reduction of the barriers to social and economic access, and improved transportation planning and facilities.

Management of the office market and the flow of public benefits is possible in the context of a thriving growth economy in Boston.

The Downtown-Financial District Class A Office Market

The Downtown Financial District Office Market is performing spectacularly with low and declining vacancy rates, high absorption rates, and prospects for an excellent match of expanding supply and growth in demand over the next five years (1986-90). The Downtown Financial District is the principal office market in Boston, and is complemented by the Back Bay District and the Government and other District which make up the three components of the Boston office market in this analysis. The Class A office inventory includes office buildings constructed after 1960 (or rehabilitated to new condition), with 20,000 square feet of space or more, commanding rentals of $20 a square foot or more, and located in the Financial District, Back Bay the Government Office Area, the Retail District, or Fort Point Channel.

The Downtown Financial District, with 19.8 million square feet of Class A space, including 16.6 million square feet of Tower space, makes up 74% and 80%, respectively of the City's Class A and Tower space, as of 1986. The Downtown Financial District will sustain its dominance in the next five years and beyond. Judging by the known pipeline of supply, 1986-90, the Financial District will add 4.8 million square feet of Class A office space, out of a city-wide addition of 6.9 million square feet (70%), including 3.8 million square feet of Tower space, (79% of Financial District increment). Class A office development in the Downtown - Financial District, in this period, will be dominated by International Place I, Rowes Wharf, 75 State Street, Marketplace Center, 101 Federal St., 101 Arch Street and 150 Federal Street, - coming on stream principally in 1987 and 1988.

The Class A office vacancy rate in the Financial District is 6.0%, as of third quarter 1986, in comparison with 8.8%, in 1984, and 10.3% in 1985. The Boston Redevelopment Authority projects this rate to rise to a high of 10.8%, in the first quarter of 1988, as 3.4 million square feet of new space enters the market over the next six quarters. With an additional 1 million square feet of space coming on to the market by year-end 1988, the vacancy rate for the last quarter is projected at 9.3%. Thereafter, with no new space scheduled through 1990, vacancies would disappear by the end of that year.

This outstanding Financial District office market perspective reflects a very strong growth in absorption (effective demand), recent and prospective. The current (3rd quarter 1986) rate of absorption of new, Class A space is estimated at 9.6%, in comparison with 9.7%, in 1984 and 9.9% in 1985.

The current absorption rate in the Financial District exceeds that for the city as a whole (7.9%). For the future, the absorption rate is projected to recede modestly to 7.2% by year-end 1988, with the occupancy of 3 million square feet in the interim, and to dwindle thereafter to year-end 1990 as new supply evaporates. In effect, the Downtown-Financial District absorbed 1.5 million square feet of Class A space in 1984, 1.7 million 1985, and will have absorbed an estimated 1.9 million by year-end 1986. Absorption is conservatively projected at 1.6 million, in 1987, 1.6 million in 1988, and 1.2 million yearly in 1989 and 1990.

Beyond 1990, the general outlines of the growth economy and office space demand and supply are emerging as strong shadows not yet etched in concrete.

Nevertheless, the prospective strength of the Boston economy and the demand for office space, on the one hand, and the role of Financial district office development are reasonably clear, and indicate a continued preeminence for the Financial District. The post-1990 generation of Financial District Class A office development is sure to be weighted by the Fan Piers, Bedford-Essex, International Place II. Long-term development in the Fort Point Channel area is an open question for future planning and development, and includes the ingredients of very large scale public (state) infrastructure requirements, community concerns, housing needs and potential, and due respect for the City's responsibility in determining appropriate land uses through zoning and planning.

Boston's Office Market Mid-Year 1986

With office vacancies declining, and space absorption high, Boston's office market is in good health, as of mid-year 1986. The momentum of the Boston Office market was sustained by a record three years of office employment growth. Office building value appreciation has also emerged as a factor with newly constructed buildings reselling at prices beyond development cost, reflecting declining interest and property tax rates (and consequent higher capitalization multipliers) as well as rising rentals, low vacancies, and notable prospects in a market with land scarcity and a tightly constrained project approval process. In the meantime, the suburban market is softening with high vacancy rates, few Class A structures, dispersed locations, low or negative operating income, and limited value appreciation. In addition, prospects for the future, near-term and long-term, are outstanding in view of the recent performance of the City's economy, and favorable national prognoses

for New England and the Metro region, and the broad range of services, communications and money management activities that make up a growing share of Boston's economic base.

Vacancy Decline

Following record rates of office development and space absorption in 1984, vacancy rates had risen to 11.5% in Spring 1985, receding to 8.5% in the Fall, and melting further to an estimated 8%, as of mid-year 1986. Boston's good fortune is outranked only by the 7.3% and 7.6% vacancy rates of New York and Washington, D.C., respectively.

High Absorption

Net office space absorption in the first half of 1986 was reported at 1.4 million square feet (by Spaulding & Slye), exceeding the annual average of 1 million square feet, 1970-1983 (as reported by the Building Owners and Managers Association). Full year 1986 net absorption is expected to surpass 1.8 million square feet, closely approaching the 2.1 million square feet absorbed in the record year 1984.

Strong Demand

The strong demand for office space responded to a three year employment gain of 25,000 + jobs, mostly office related, setting a new mark in Boston. A scheduled net addition of 1,346,000 square feet of office space in 1986 will cap a three year increment of 6.2 million square feet of supply in the 1984-85-86 years.

Value Appreciation

Beyond the strength of office market demand, appreciation of value is adding another dimension to the attraction of office development in Boston. Newly constructed Boston office buildings are currently fetching prices far above actual development costs. A predictive equation demonstrates how income capitalized value has been enhanced by high rental rates (second only to New York and San Francisco), low vacancy rates, declining interest rates and the long-term prospects for appreciation of income producing property in Boston's broad based economy, with limited space and managed development.

Quality Upgrading of Demand and Supply

Office building value has also benefitted from the increase in demand for quality office space as well as its supply, adding another fillip to the incentive for development. The demand for quality space has been stimulated by the more rapid expansion, recent and prospective, of small and medium sized business and professional services activities firms with their richer mix of professional, managerial and technical occupations, in comparison with the slower growth of the large bank and insurance corporations with their phalanxes of lower skilled secretarial and clerical workers. The enhancement of demand quality (and rental rates) has been matched by an extraordinary upgrading of supply. Large-scale rehabilitation of older office buildings, especially since 1979, has rapidly dwindled the City's stock of Class C office space, and contributed to the rise in office rents and values.

Softening Suburban Market

The current condition and prospects for the suburban office market are decidedly less favorable than those for the City of Boston, and, consequently, further advance development interest and prospects in the Hub. Vacancies in the suburban market are high, at 18% (according to Spaulding and Slye), paralleling the national level which has led to a slow-down in office development in many cities across the nation. Suburban office development, made up of distinct office centers in more than a dozen cities and towns, had mushroomed spectacularly in the past decade in response to high-tech (Cambridge, Lexington, Waltham), back-office (Quincy and Woburn), and regional headquarters (Wellesley and Burlington) demand, but these specialized facets of demand are growing more slowly now. The dispersed office space is not geared to broad markets or labor force supply.

Non-market factors also adversely impact the suburban office park. More than half the suburban office space is in structures of less than 50,000 square feet; less than 5 percent of the space is in buildings of 100,000 square feet and over. Federal Tax reform will adversely affect tax incentives for development investment embodied in currently available tax shelters and depreciation, thereby forcing more exclusive reliance on market considerations as the fulcrum for investment. The suburban office market, already suffering from lower rates of value appreciation and income capitalization because of lower rentals, higher vacancies, and low or negative income, will be more severely affected by tax reform and the diminution of non-market incentives for investment.

Boston's Class A Office Market

Boston's private Class A office inventory has grown from approximately 16 million square feet in 1980, to 26.8 million square feet in the third quarter of 1986-- 19.8 million in the Financial District, 5.7 million in the Back Bay, and 1.3 million in the Government Area and other areas of Downtown. The entire Boston office market (including Class B and C buildings) consists of approximately 43 million square feet.

Demand (absorption) over the past five years has averaged 1.6 million square feet a year, and, over the past three years, 2.6 million. This substantial increase in effective demand reflected Boston's booming services economy, and was facilitated by very substantial new construction (especially a record level of completions in 1984) and the significant volume of Class B rehabilitation and conversion. Future office space demand, as seen in projections of office employment as well as the extension of recent trends, may be expected to absorb 1.6 million to 2.0 million square feet a year in the period 1986-90. Thus far, in 1986, over 1.4 million square feet has been absorbed; and, since almost 500,000 square feet has been pre-leased in buildings scheduled to be completed this year, absorption should readily surpass 2 million square feet by the end of the year.

For the period 1986-90, a projected 7 million square feet of new supply of Class A space city-wide would be matched by a projected growth in demand of 7.7 million square feet, averaging 1.8 million square feet annually.

Long-Term Prognoses, to the Year 2000

Recently reported national analyses and projections for New England, Massachusetts and the Boston Metro Region shed important light on trends and prospects for the Boston economy and the office market. Reports of the U.S. Bureau of Economic Analysis, in 1985, with projections to the year 2000 and beyond, identified New England as "a high growth region" and forecast very substantial economic expansion to the year 2000, for the Boston Metropolitan Region, with improvement in its ranking, among the Nation's 330 metropolitan areas, from 7th to 6th in the level of personal income, from 15th to 11th highest in per capita personal income, form 6th to 5th in population, and from 5th to 4th in employment. Significantly, Boston's office related finance, communications and business and professional services activities are among those expected to rise most rapidly.

More recently, the Joint Economic Committee of the U.S. Congress issued a report (July 1986) on "Regional Patterns of Economic Growth", 1981 1st Quarter to 1985 4th Quarter, and found the six states of the New England Region to be in the top 19, and that Massachusetts was 4th highest in growth rate in earned income in this period.

Most significantly, the National Planning Association, a highly regarded private, non-profit research organization, published a study entitled "Employment Growth In Metropolitan Areas 1985-2000" and forecast that the projected jobs gain in the Boston Metropolitan Region (+ 775,000 to the year 2000) would be second in the Nation in magnitude, excelled only by the gain of 1,032,000 jobs foreseen for the Los Angeles Metro Region.

For the Boston Metro Region, looking to the year 2000, the prognoses of the U.S. Bureau of Economic Analysis and the National Planning Association would represent a one-third expansion in employment, about the same as the 1976-85 increase, but reflecting a lower rate of growth. Boston Metro would be favored by a superior economic base with relative concentrations in those high-technology, communications, finance, and business and professional services activities rising most rapidly nationally.

The Boston Economy In the Year 2000

Boston will fare well with its notable recent growth and structural transformation attuning it to the high-grade and high growth sectors of the national and metro region economies. Projections for Boston, related to those of the metro region and an analysis of recent trends and prospects for the City's economy, suggest a continuation of the 1976-85 employment growth rate, which, though less than that anticipated for the metro area and the suburban ring, foresee a gain of 154,000 jobs, 1985-2000, about 10,300 jobs a year (in comparison with the 1976-85 advance of 9,200 jobs a year).

The Boston Office Economy Toward the Year 2000

The Office Economy will loom larger in Boston's future, extending its rising share of the City's employment, doubling the Class A office inventory, and expanding the total supply of office space by two-thirds, by the year 2000, assuming office development comes on line to meet projected demand. Office related employment, whose share of the Boston economy rose from 1976 to 1985, is expected to further enhance its share and add 115,500 net new office jobs in the 1985-2000 period, advancing the City's office employment from 177,000, in 1985, to 293,000, in the year 2000.

Sharing the Metro Market, City & Suburb

In 1975, Boston made up two-thirds of the Class A metro office market of 20 million square feet. By 1986, this market had increased three-fold (to 60 million square feet), Boston's Class A space had more than doubled, but its share of the metro market had fallen to one-half, as development of the suburban office parks shot ahead.

To the year 2000, rising demand in a thriving metro area will require a doubling of the Class A office stock, to 120,000,000 square feet. In this period, however, city-suburban trends will shift, with Boston gaining more than half of the projected Class A increment, reflecting the extraordinary attraction of its upscale, inter-related, integrated office economy.
The suburban office market will grow, but at a lesser rate, impacted by a high vacancy rate (18%), softer demand, lower value appreciation, and a fragmented inventory.

How Boston's Realty Brokerage Firms View the Boston Office Market

Boston's expanding roster of office realtor brokerage firms issue regular survey reports which vary in coverage, format and timing. Their recent findings, nevertheless, have a common thread: Boston vacancies are declining, absorption is high, and demand is strong; in the suburban market, vacancies are high, the Cambridge market is weak, leasing in the suburbs is active.